

IV. Financial Management

So important is the financial stability of a local water supply utility that this final section of the self-assessment instrument is devoted solely to helping you measure the financial health and fiscal management sophistication of your local system. Water systems must be run as businesses, whether they are owned publicly or privately and, while the private water company is almost always required by its shareholders to earn a profit, public systems must take in enough revenue to be able to **reserve** sufficient funds to cover emergencies, pay debt when revenues fall, and replace aging equipment. These are not easy tasks in today's economy.

A. The Basics

1. Is there an accurate operating budget, and do *operating* revenues equal operating expenditures? (Operating revenues *exclude* all funds earmarked for debt service.)

2. Is there an annual independent audit of water system accounts by which to prove the accuracy of the operating budget? (* see note below)

3. Is there an operating cash reserve, and is it equal to or greater than one-eighth of the annual operating budget?

*First and obviously, operating revenues must equal or be greater than expenditures. An operating ratio (operating revenues as compared to operating expenditures) should be at least 1:1 as a basic fiscal requirement; the ratio should be at least 1.125: 1 if the operating cash reserve is included in the calculation. The operations cash reserve is intended to fund short-term emergencies and to smooth out seasonal cash flow fluctuations. The capital cash reserve is for funding emergency repairs to major equipment, or replacement.

4. Is there a capital cash reserve? Is it equal to or greater than 5% of the total replacement value of the physical plant?

5. Is the water system budget set up as an enterprise account, separate from the community's general fund, and audited separately?

6. Is there a capital improvement plan? What is the planning period encompassed by the CIP? Who participates in the annual updating of the plan, and how are priorities set?

7. How often is the water rate structure officially reviewed? Is there legal provision for water rates to be raised on an as-needed basis, subject to a pre-set ceiling, or according to some index of inflation?

8. What is the average annual increase in the Operations and Maintenance budget over the last five years? How do these increases compare with inflation rates over the same period? (*see note below)

*Operations and Maintenance costs for water treatment and distribution will increase in direct proportion to increases in the numbers of customers, increases in the complexity of treatment and the length and volume of distribution and storage systems, and increases in the cost of electricity. As systems age more overtime pay is required, because there are more equipment breakdowns. Small systems are victims of diseconomies of scale, and thus must have a clear understanding of the **real cost** of adding new customers and/or continuing to operate with aging infrastructure.*

9. What is the increase of new customers during the same period, and what percentage of the total customer base do these new (last five years) customers represent?

10. What is the total number of new jobs added at the water system during the last five years, and what additional payroll burden has been added by these new jobs?

11. For each of the last five years, what is the approximate percentage of total payroll represented by overtime pay? Is there a significant trend upward?

B. Budget Analysis

Timely budget analysis will assist administrators and policy makers to make more accurate future budgets. The issues of fairness and sufficiency are particularly important, for they are the basis for the public's perception of the quality of the water system, and for the political leadership's acceptance of its rate structure and operating policies. Budget making cannot proceed rationally without good information about historical trends in costs for labor, energy, equipment and supplies.

1. Does the system routinely do an analysis of line item expenditures, so that specific annual costs (labor, energy, etc.) may be compared to those from past years?

2. Does the system routinely analyze its revenue stream, so as to be able to compare, from month to month and year to year, its budgeted revenues to revenues actually received? What are the categories of revenue included in the analysis?

3. Does the system regularly calculate its operating ratio? How often?

4. Does the system regularly calculate net monthly (or quarterly) operating charges by **type of connection**, so that it may allocate net operating costs according to the total system demand originating for each type of user (e.g. residential, industrial, commercial, etc.)

5. Is there a separate capital budget, based on future per capita consumption estimates, known capital replacement needs (as outlined in a CIP) and other forecasts in local and regional planning documents?

6. Can the system show the **fairness** of its rate structure, by showing that it is recovering costs from customers in precise proportion to the cost of service to those customers? In addition to the basic customer categories of residential, commercial and industrial, what other customer categories are included in the rate structure?

7. Can the system show the **sufficiency** of its rate structure, by showing that it is generating adequate funds for all the O&M, capital and debt service needs of the system?

8. Have system administrators compared the cost of their water (a) to the state-wide average, in both metro and non-metro areas, (b) to the cost in nearby communities or service districts, and (c) as a percentage of median household income? Is the cost appropriate and in line with what others are charging?

9. What is the debt service **coverage ratio** of the budget (total revenue **minus** operating expenses, divided by all debt service expenses)? Is there any required coverage ratio imposed by specific lenders?

10. Has the general fund of the community had to lend funds to balance the water system enterprise fund at the end of any fiscal year in the last five? Why?

C. Rates

1. Is the current rate structure composed of both a **fixed** and **variable** portion, corresponding to recovery of those costs (a) which will not vary significantly with the volume of water produced (labor, debt service, insurance etc.), and those (b) which are principally a function of the volume of water produced (energy, supplies, equipment repair, etc.)?

2. Is the fixed portion of the water rate based on the size of customers' meter connections?

3. Is the variable (consumption based) portion of the rate the same or different for different classes of users? How? Why?

4. Are higher rates charged to consumers located outside of the political jurisdiction that owns the system? Differential?

5. As customers use more water, are they charged more per 1000 gallons, or less? Why?

6. Are any special rate structures in place, such as seasonal, contract rates for industry, off-peak rates, incentive rates, etc. Describe.

7. What is the duration of the present rate structure, and is it “forward-facing,” in the sense that it attempts to recover average costs over a multi-year period?

8. Are government and institutional customers charged for their water? If given to them, is consumption metered?

9. Has the rate structure (including connection fees) been adapted to help achieve a specific development goal, such as residential growth, or industrial relocation?

10. Do any state laws restrict rate setting flexibility for publicly owned systems in your state?

D. Money Management

1. Does the system have access to an interest bearing account or fund into which deposits of short term excess cash may be made?

2. What percentage of customers' bills are typically more than 90 days overdue? Is there a written delinquent account policy?

3. Are receipts managed according to procedures prescribed by modern accounting practices? Are they deposited daily?

4. Are system bills paid promptly, so that interest charges are avoided? Do cash flow problems occasionally delay bill payment?

5. Does the system have a financial advisor?

6. Does the system routinely refinance debt to take advantage of lower interest rates?

7. Are annual audits performed? Are they performed by an independent auditor? In the course of recent (last five years) annual audits, have there been any audit exceptions? Have the auditor's Management Letters found any exceptions to current management practices?

8. Are the financial manager(s) regularly trained in asset management techniques?

9. Are the system managers currently up to date on federal and state grant and loan financing programs and able to take full advantage of them?

10. What is the community's current bond rating? If below AAA, why?

Summary of Financial Management

This section is meant to help you evaluate and prioritize the challenges faced by the system's financial management. Looking back at the information you provided in preceding section and what you know of the system, summarize defects and deficiencies noted above and then prioritize them according to their justified need. Using the ranking system provided below, complete the table found on the following page.

*Priority Ranking System**

1 =	Issue presents an imminent threat to public health or safety <u>OR</u> issue presents a current Safe Drinking Water Act compliance problem
2 =	Issue presents a potential or future threat to public health or safety <u>OR</u> issue presents a potential or future Safe Drinking Water Act compliance problem
3 =	Issue impacts negatively or could impact negatively system performance or efficiency, but does not present an immediate threat to public health, safety, or compliance with the SDWA
4 =	Issue presents a future threat to the long-term capacity of the system

*Note: Although an issue might be categorized as a “3” or “4” priority today, you can be sure that it will become a higher priority at some point in the future. It is wise to fix these problems sooner rather than later, when more may be at stake and it might cost more to fix.

Summary of Issues Related to Financial Management

ACTION ITEM	PROBLEM / CONCERN	CORRECTIVE ACTION REQUIRED	COST	OTHER RESOURCES REQUIRED	PRIORITY <i>(see ranking system)</i>

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